The Premier Association of Real Estate Finance

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STATEMENT OF

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on behalf of the

Mortgage Bankers Association of America

before the

Subcommittee on Benefits

of the

Committee on Veterans' Affairs

U.S. House of Representatives

Hearing on
H.R. 5111, the "Servicemembers' Civil Relief Act"
and
H.R. 4017, the "Soldiers' and Sailors' Civil Relief Equity Act"

July 25, 2002

Mr. Chairman and Members of the Subcommittee, my name is James Murphy. I am the Chairman and CEO of New England Realty Resources, Inc. and appearing before you today in my capacity as Chairman of the Mortgage Bankers Association of America (MBA)[1].

MBA appreciates the opportunity to testify at these hearings on H.R. 5111, the "Servicemembers' Civil Relief Act" and H.R. 4017, the "Soldiers' and Sailors' Civil Relief Equity Act." These bills are intended to clarify existing provisions of the Soldiers' and Sailors' Civil Relief Act (SSCRA) and expand the protections offered to our Nation's armed servicemembers. We applaud these laudable objectives, and would like to offer our views on the planned changes, as well as the existing SSCRA framework.

At the outset, let me state that the mortgage banking community is extremely thankful to our country's military for their service and protection of the citizens of the United States and our way of life. There is no question that these brave men and women deserve special consideration and benefits for the risks they take to ensure our safety. The Soldiers' and Sailors' Civil Relief Act provides servicemembers with important protections against financial distress and economic hardships during their call to active duty. From the business side, however, our overarching concern with the current framework of SSCRA is with the disproportionate financial responsibility placed on the private lending sector to provide these benefits. The total size of the subsidy is significant and we believe it would be more aptly and appropriately funded by the federal government.

Summary of H.R. 4017 and H.R. 5111

Before going into specific comments, I would like to summarize the basic provisions of each bill.

H.R. 4017

H.R. 4017 expands the protections offered in SSCRA to members of the National Guard that are called for state duty, but who are paid with federal funds. The intended recipients of these benefits are members of the National Guard called to protect the country's airports as part of Homeland Security. The legislation is not intended to cover incidences where the National Guard is called to assist in a Presidentially declared disaster, such as a flood or hurricane.

We believe this is a fair and equitable bill as some members of the National Guard currently receive SSCRA protections, while others do not. Approximately 1,800 additional members of the National Guard would be assisted today by this change.

[1] MBA is a trade association representing approximately 2,600 members involved in all aspects of real estate finance. Our members include national and regional lenders, mortgage brokers, mortgage conduits, and service providers. MBA encompasses residential mortgage lenders, both single-family and multifamily, and commercial mortgage lenders.

H.R. 4017 or H.R. 5111, however, should assure some equality in the responsibility to absorb the cost of expanding the scope of the law. Fannie Mae and Freddie Mac are currently incurring this cost on loans they purchase or mortgage-backed securities (MBS) they guarantee even though not mandated to do so under SSCRA. We believe Ginnie Mae, as guarantor of its MBS and as a government agency, should bear the cost for VA and FHA loans pooled into MBS.

H.R. 5111 and the Interest Rate Ceiling

The stated goal of the sponsors of H.R. 5111 is threefold:

- to clarify the law by making SSCRA easier to understand by restating it in plain language;

- to improve the law by incorporating generally accepted procedural practices; and

- to adjust its provisions to reflect developments in American life since 1940.

We fully support these goals. We are certainly aware of the significant changes that have occurred in the mortgage markets over the last 60 years. An effort to modernize the Act in recognition of these market changes is a worthwhile endeavor.

As mortgage bankers, we are most profoundly affected by the Act's interest rate ceiling and thus will limit our testimony to Section 207 of H.R. 5111 (and H.R. 4017). As you are aware, SSCRA currently caps the maximum interest on servicemembers' obligations existing prior to entering into military service at 6 percent. The Act provides little guidance on the mechanics of applying the interest rate cap. H.R. 5111 is designed to resolve some of these issues. In particular, Section 207 of H.R. 5111:

1. Restates current law that provides a reduction in interest rates to 6 percent on obligations and liabilities entered into prior to military service;

2. Strengthens the Act by requiring that the interest rate differential between the note rate and the 6 percent cap be forgiven rather than postponed;

3. Requires the lender to adjust the periodic payment to reflect a reduction in the interest rate. Upon a borrower invoking SSCRA protections, a lender could not require the same periodic payment and merely apply more of the payment to principal;

4. Requires written notice to the creditor of the servicemember's call to active duty and a copy of the servicemember's orders; and

H.R. 5111 also restates certain provisions of the Act dealing with stays from eviction and foreclosure. While mortgage lenders are impacted by these stays, they are

affected to a much lesser extent because these events only occur when the borrower is experiencing a hardship and is unable to make his or her payments. The interest rate ceiling, conversely, is not predicated on a hardship. In fact, the only limitation imposed on receiving the subsidy is that the debt must be pre-existing to the servicemember's military service. Theoretically, a servicemember who receives both his or her civilian income and Reservist pay would still be eligible for the 6 percent interest cap despite the lack of financial hardship. While the Act does permit the lender to apply to a court to have the interest rate ceiling removed, such an option is costly, cumbersome and places lenders in an adversarial position with their customers.

Mortgage Lenders' Commitment to Servicemembers

Let me state that the mortgage industry is strongly committed to helping our military men and women. We continue to fully comply with the requirements of SSCRA. In fact, in some instances, our members have gone beyond the current requirements and lowered the interest rates of military personnel not covered by the Act. For example, we are aware that some lenders are currently granting relief to members of the National Guard called to duty by the state, despite the fact that they are not required to do so by law and are not reimbursed for this cost by Ginnie Mae.

As an industry we have made every effort to ensure that our Nation's servicemembers are notified of their rights. In response to Operation Enduring Freedom, MBA ran advertisements in the Washington Post, Navy Times, Air Force Times, Army Times and Marine Times. These advertisements were designed to alert military personnel that they may be eligible for an interest rate reduction and that they should contact their lenders to seek relief. We are committed to our borrowers and to preserving our customer relationships. We believe these extra steps underscore our commitment to assisting eligible servicemembers under SSCRA.

Need for a Federally Funded Program

Because it is the stated goal of the sponsors of H.R. 5111 to ensure that SSCRA reflects modern America, we believe it is appropriate and necessary for the Act to reflect significant developments in our financial markets since1942 and to recognize that as a result of these market changes, the Act has become a large subsidy program funded primarily by the private sector lending community. To the extent that Congress wishes to provide a broad benefits package to our country's military, the responsibility to fund such public policy is more appropriately placed with the federal government and all taxpayers that benefit from the protections offered by our military.

MBA estimates that under current SSCRA obligations, the private sector (mortgage lenders, Fannie Mae and Freddie Mac) and Ginnie Mae are absorbing approximately $2.6 million in interest rate losses a month, or $31 million a year. This is certainly not a small subsidy and could not have been the intention of the original drafters of the legislation.

The Act was originally passed in 1940, and subsequently amended in 1942 after the United States entered World War II. The 1942 Amendment included the interest rate provision that remains basically unchanged today. When the 1942 Amendment was passed, interest rates were lower than they are today. The FHA mortgage rate in 1942, for example, was 4 ½ percent--a rate 33 percent lower than the 6 percent cap. Given these facts, it is reasonable to assume that Congress in 1942 intended to conform the Act to the lending conditions of the time and did not intend to adversely affect the mortgage lending community. By contrast, the average interest rate today on outstanding mortgage obligations is 7 - 7¼ percent.

Implications of the Secondary Market and Securitization

One of the continuing issues of concern for mortgage lenders and servicers is who is responsible for absorbing the interest loss. Both the Act and H.R. 5111 remain silent on this point. However, due to a number of changes in the mortgage market and the birth of the secondary market, the current responsibility flows generally to the mortgage servicer. Since the original passage of SSCRA, there has been a virtual revolution in the mortgage finance system with the birth of the secondary mortgage market. The flow of mortgage capital has been completely altered as a result of securitization. The mortgage servicer, which historically received and retained the interest payments, is not necessarily the beneficial recipient of the interest payments today.

In the 1940s, the vast majority of mortgages were originated by savings and loans, banks and life insurance companies. These institutions held the loans in their portfolios and received monthly principal and interest payments from borrowers until their debts were repaid. The creation of the mortgage-backed security and development of the secondary mortgage market completely and forever altered the mortgage finance system and roles of mortgage lenders.

In the secondary market, mortgages are pooled into mortgage-backed securities and sold into the capital markets. The servicing rights to those mortgages are stripped from the loan as separate assets and can be either retained by the originator or sold to a non-affiliated servicer. Today, the vast majority of mortgage lenders no longer hold whole loans. Approximately 80 percent of all originations are sold into the secondary market. The majority of conventional conforming loans are sold to Fannie Mae and Freddie Mac or pooled for MBS. Loans insured by FHA or guaranteed by VA are pooled into Ginnie Mae securities. Jumbo and non-conforming credit loans are held in portfolio or sold to private investors and securitized as private-label MBS. The largest holders of residential MBS are institutions investors, such as mutual funds, pension funds, depository institutions, and life insurance companies.

The change in beneficial ownership of the loans is significant because mortgage originators and servicers are no longer necessarily the ultimate recipients of interest payments Mortgage companies, who originate the bulk of mortgages today, sell the vast majority of their originations into the secondary market. As a result, they merely

pass through interest received from the borrower to the securityholders. In exchange for performing this and other administrative functions, such as collecting monthly payments, administering escrow accounts, performing loss mitigation and foreclosures, the servicer receives a servicing fee. The normal servicing fee is 25 basis points or ¼ of 1 percent of the loan balance per year for Fannie Mae and Freddie Mac loans and 44 basis points a year for loans guaranteed by Ginnie Mae. On a $100,000 conventional loan, therefore, the mortgage servicer receives $250 a year. That figure does not recognize the expense to administer a loan, which averaged $79 per loan in 2001 according to MBA's Cost of Servicing Study.

The cost of SSCRA's interest rate subsidy on a typical loan far exceeds the servicing revenue earned for that loan. The cost to the servicer is not just a loss of the servicing fee. As a result of securitization arrangements with Fannie Mae, Freddie Mac and Ginnie Mae, servicers are generally required to remit *scheduled* principal and interest regardless of whether it is collected from the borrower. In turn, Fannie Mae, Freddie Mac and Ginnie Mae guarantee the ultimate holders of the securities that they will receive timely interest and principal regardless of whether the servicer remits the funds. These guarantors receive a guaranty fee for providing this credit enhancement. In sum, as a result of investor requirements, when a servicemember invokes the SSCRA interest cap, the mortgage servicer must still pass through the scheduled coupon rate despite receiving only 6 percent interest on the debt. The interest deferral results in a loss to the mortgage servicer if not reimbursed. To advance the scheduled interest to the investor, a servicer often has to borrow the funds.

Secondary Market Investors' Role in Absorbing Interest Losses

The imposition of the 6 percent cap on mortgage lenders and servicers can significantly impact the financial stability of individual companies. However, the risk to lenders today is significantly reduced because of the generosity of the secondary market players. Today, Fannie Mae, Freddie Mac, and Ginnie Mae, as guarantors of MBS, have all agreed to reimburse servicers for most of the interest deferential. We are extremely grateful to these entities for their financial assistance. They should be commended for their proactive efforts.

It is important to point out that even with the tremendous financial assistance of Fannie Mae, Freddie Mac and Ginnie Mae, mortgage servicers and issuers continue to incur significant costs to implement the interest rate cap in SSCRA. Mortgage lenders that retain loans in portfolio absorb the interest loss, as do some issuer/servicers of private-label MBS backed by jumbo loans, subprime loans, home equity loans and other non-conforming products. MBA estimates there are $1.435 trillion in non-conforming debt outstanding. Unfortunately, we are unable to determine what percentage of this number represents SSCRA eligible loans.

Also mortgage servicers incur the cost to carry interest rate advances to the investors as they await reimbursement (usually provided on a quarterly basis). Finally, mortgage servicers continue to absorb interest rate losses on SSCRA eligible loans that are not

approved by Ginnie Mae for reimbursement. Today, Ginnie Mae only reimburses servicers if the servicemember is on one of the following approved operations: Bosnia, Kosovo, S.W. Asia and Enduring Freedom. Servicers also absorb the cost of members of the National Guard protected by SSCRA pursuant to state law. Fannie Mae and Freddie Mac conversely reimburse for all SSCRA eligible loans and have gone beyond the requirements of SSCRA and extended the protections to these state-called members of the National Guard. It is important to state that our comments are not a criticism of Ginnie Mae; rather, they are an explanation of why the mortgage industry, as a whole, needs assistance from Congress.

Recommendations

As this Subcommittee deliberates H.R. 5111 and H.R. 4017, it is imperative that the Subcommittee addresses the issue of the interest rate ceiling. We recommend the following:

- First and foremost, the legislation should provide for the creation of a federal mortgage interest rate subsidy program that is funded by the federal government for use by eligible servicemembers. A government program would more equitably distribute the cost of providing these valuable benefits to all taxpayers who benefit from the activities of our military.

- To the extent that a government program is not funded, the legislation should increase the interest rate ceiling so that the subsidy offered in today's interest rate environment is comparable to that in 1942. In order to avoid the continuous need to amend the Act through various interest rate cycles, we suggest a margin over 10-year Treasury securities or other appropriate index. Our recommendation is consistent with the sponsors' objective to adjust triggering events to reflect today's economy. In particular, H.R. 5111 recognizes changes in the rental market by providing servicermembers with protections against eviction when monthly rental payments are $1,700 and below. Currently that trigger is set for rents of $1,200 or below. Adjustments to the Act should not be one-sided, but should reflect other relevant changes in the marketplace even if they benefit creditors.

- H.R. 4017 and H.R. 5111 should be amended to provide that Ginnie Mae will reimburse lenders for all eligible SSCRA loans that are pooled into Ginnie Mae MBS, including the additional members of the National Guard brought within the protections of SSCRA by H.R. 4017.

- Legislative safeguards should be enacted to prevent abuse of the protections afforded under SSCRA. For example, the Act should not encourage servicemembers to use SSCRA to avoid paying their debt obligations. Likewise, SSCRA should not encourage individuals to obtain market rate loans in anticipation of entering military service for the purpose of ensuring a below market rate loan for their entire military careers. It is our belief that

SSCRA was intended to provide temporary relief from economic distress while on active duty to fight a war. We do not believe it was designed as a means to fund a mortgage loan subsidy program. Although a lender can bring suit in a court of law to deny the 6 percent interest rate, the process discourages prosecution of abuse.

- The bills should provide for effective dates that are 90-days after the dates of enactment in order to allow sufficient time to communicate the changes to lenders, update systems and processes as necessary, and provide training to ensure compliance with the laws.

- While mortgage lenders and investors are currently forgiving the interest differential, we are concerned with H.R. 5111 codifying what we believe is a voluntary activity unless the federal government is willing to assist in defraying the cost.

Finally on a more technical note, we would like to comment on the more operational aspects of Section 207 of H.R. 5111:

- Section 207(a)(3) requires the lender to adjust the periodic payment to reflect any reduction in the interest rate. Under that provision, a lender would not be able to keep the current periodic payment and merely apply more of the payment to principal. Unfortunately, this provision could also be read to prevent a lender from applying more of the adjusted monthly payment to principal, which would necessarily result from the reamortization of the loan at 6 percent. Moreover, in the event that the servicemember voluntarily remits more than required, the lender should have the ability to apply the funds to principal, as is currently done. We believe this provision should be revisited because prepayment of principal accrues to the benefit of the borrower.

- Section 207(b)(1) requires the servicemember to provide a creditor with written notice and a copy of the military orders. The provision allows the borrower to submit this written request "not later than 180 days after the date of the servicemember's termination or release from military service." Such notice should be provided much earlier in the process so that the servicemember may benefit from the lower monthly payment while on activity duty and potentially faced with reduced pay.

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MBA appreciates this opportunity to share our views on H.R. 5111 and H.R. 4017. The mortgage finance industry will continue to comply with the requirements of the Soldiers' and Sailors' Civil Relief Act today and in the future. However, we strongly believe that to the extent the federal government wants to provide an interest rate

subsidy to servicemembers, it should provide the funds to support such a program or improve the military pay to help cover housing expenses while on active duty.

We would be happy to furnish any additional information you may need.